

Observations

- ❑ A variety of informational sources are relied upon to guide QRS clients towards their financial goals. The most credible sources are warning of a pending financial disaster ahead. It is not a question of “if”, but “when” the financial and economic volcano erupts. The unknown is will it be a sudden, violent eruption or one in which the hot lava simply overflows and spreads down the mountain scorching everything in its path. Either way, a day of reckoning for the world’s economies is approaching.
- ❑ The primary point of debate between economists is when the financial volcano erupts will the result be deflation or inflation? The deflation camp contends that a recipe of increased government regulations that will stifle innovation and productivity combined with de-leveraging, excess capacity, and increased saving will weaken world demand thereby forcing prices lower. The inflation faction point to the expansion of the money supply, the need for additional tax revenue, and competition for scarce resources (i.e. energy, food, water, timber...etc.) will continue pushing prices higher. The truth is somewhere in-between with a destructive outcome.

Facts & Figures of Importance

Economic

For How Much Longer Can It Remain Your Father’s Dollar?

Since the end of WWII, the US dollar has been the reserve currency of the world. Approximately 85% of foreign-exchange transactions world-wide involve the US dollar. In 2001, that figure was 90%. Over the past ten years, the dollar’s share of global foreign-exchange reserves has fallen from 72% to 61%.

The declining financial condition of the US is making it a prudent decision for other countries and organizations to diversify their currency holdings. China and Japan will promote direct trading using the yuan and yen while forgoing dollars. India will pay for oil purchased from Iran in gold (protecting India from US sanctions for countries trading with Iran).

The dollar will likely remain a safe-haven in times of economic upheaval. There is also missing a single alternative to the dollar. Safe currency countries like Switzerland, Australia, or New Zealand cannot be expected to carry the world. The days of a gold standard are in the past. However, it would be comforting to know that fiat currencies like the dollar are backed by something more than promises of politicians.

Economic Outlook

- The housing market is expected to remain soft for the next few years due to a combination of excess inventory, foreclosures, and uncertainty keeping folks on the sidelines. Demographics are another key as baby boomers age and will start downsizing over the next 15-20 years. Not much incentive to jump in yet.
- Both the Treasury and Fed believe that printing and spending money will eventually resolve the US economic morass. It would not be surprising to see the Fed announce another QE plan.
- Beware of any headline which implies the Greek debt crisis has been resolved. The EU still has a long, tough road ahead.

Financial

	Treasury Yields		Equity Markets		
	5 Year	10 Year	MSCI EAFE	S&P 500	DJ Wilshire 5000
2007	3.45%	4.04%	2,253	1,468	14,819
2008	1.94%	2.96%	1,237	896	9,087
2009	2.69%	3.85%	1,581	1,115	11,562
2010	2.06%	3.38%	1,658	1,258	13,360
2011	0.83%	1.89%	1,413	1,258	13,190
1/31/12	.71%	1.83%	1,487	1,312	13,839
YTD Return			5.25%	4.48%	4.92%

Market Weighted vs. Equal Weighted

The calculation of most indices is based on the weightings of their capitalizations. For example the value of Microsoft, which comprises just under 2% of the S&P 500, is calculated by multiplying the share price times the number of shares outstanding. This calculation is performed for all 500 companies in the S&P 500 and the index is constructed based on weightings. Some present a case that an equal weighted index (one share of each company is included in the index so that each firm represents 0.2% of the S&P 500 for instance) offers a better representation as this methodology does not tilt towards larger capitalized companies. The equal weighted index tends to generate better results when markets reward equities with a mid-cap and value style leanings. This is likely a chicken or the egg debate.

Investment Outlook

- There is an old saying that it takes a 100% gain to make-up for a 50% loss. In other words, think about how much risk should be in a portfolio. There is currently no such investment that is “risk-free”.
- There is another saying to the effect of do not fight the Fed. How there is not a bubble forming in Treasuries would defy reality.
- With interest rates likely to remain low through 2014, be cautious when allocating to investment classes promising higher yields. Dividends and payouts can be reduced when profits decline.
- Yields on TIPS dipping into negative territory signals expectations for an eventual spike in inflation.

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Insightful Thoughts of Others

Don't talk to me about Valentine's Day. At my age, an affair of the heart is a bypass!

- Joan Rivers

I want a man who's kind and understanding. Is that too much to ask of a millionaire?

- Zsa Zsa Gabor

A successful man is one who makes more money than his wife can spend. A successful woman is one who can find such a man.

- Lana Turner

Behind every great man is a woman rolling her eyes.

- Jim Carrey

Today is Valentine's Day. Or, as men like to call it, Extortion Day.

- Jay Leno



A Few More Things

- ❑ How to solve this problem. The big four economies are the US, Eurozone, Japan, and China. All four governments have promised their populations more than they can deliver. Citizens in the US and Europe are steep in debt. The governments are neck deep in debt, especially when entitlements are included. In the end, we know the citizens will be shafted. What we do not know is will there be a victor or will there be mutual destruction of national economies?
- ❑ To paraphrase Benjamin Franklin, lenders have longer memories than borrowers. The write-off or haircut of Greek debt will open up a Pandora's Box that will last for generations. So how long will the line be for debt forgiveness? In the EU alone, Portugal, Italy, Ireland, and Spain immediately come to mind as countries likely seeking relief. What will be the incentive for other nations to repay debt in full? Which will eventually lead to why would anyone lend to these nations again? If it has not already, expect the credit pendulum to swing too far in the direction of "no".
- ❑ Credit default swaps have turned financial markets into a casino where taxpayers are forced to pay for losses. In theory a CDS makes sense to protect the owner of a bond; the reality is that these instruments have become a gambling tool for many who have no stake in a particular debt security. Jon Corzine used CDS to gamble customer deposits on sovereign debt, and regulators still have not have a clue as to \$1.2 billion in missing funds! European leaders are busily trying to devise a plan where Greece does not have to repay its debt as promised and somehow have it not labeled as a default thus triggering CDS that who knows what impact that will have on financial markets.
- ❑ The Super Bowl stock market indicator was correct again by a whisker in 2011 improving its predictive score to 36 out of 45 games (an 80% success rate). This year believers in this predictor will favor the Giants to win in hopes that the stock market rises. Two notes of caution. First, the indicator was correct in 1987 and 1991 when the Giants won the Super Bowl. However, the Giants also won the game in 2008 and we all know how that worked out for the market. The Patriots won the Super Bowl in 2002 and the market lost ground that year as the indicator forecasts. However, the Pats won Super Bowls in 2004 and 2005 and the market increased against the indicator. While the Super Bowl stock market indicator makes for interesting water cooler talk, by no means should anyone invest on the basis of a game.
- ❑ Come March expect the world to become even more bizarre. The Republican primary Super Tuesday is March 6th as the American political class simply cannot get enough mudslinging. The Supreme Court will hear arguments on Obamacare, a piece of legislation nobody has read in its entirety and if such a person is found he or she could not adequately understand it, yet explain it. Russia holds presidential elections and while we already know the results, it will be interesting to see how voters react. Greece owes \$18 billion on March 20 to bond holders who should not be expecting a check in the mail. However, the above will not be that important when you consider the amount of attention that will be given to filing out one's NCAA basketball tournament pool. Not a sports fan? You can be sure there will be some celebrity gossip that will knock the above off the front page. Bread and circuses.